ADMINISTRATIVE CONFERENCE OF THE UNITED STATES

SPECIAL COMMITTEE ON ETHICS IN GOVERNMENT

DEFERRED TAXATION OF GAINS REALIZED BY DIVESTITURE OF ASSETS BY FEDERAL GOVERNMENT APPOINTEES AND INVESTMENT FUNDS AVAILABLE TO APPOINTEES REQUIRED TO DIVEST ASSETS BY THE CONFLICT OF INTEREST LAWS

STUART A. SMITH

Shea & Gould
1251 Avenue of the Americas
New York, New York 10020
(212) 827-3316

I. Introduction

In accordance with the requirements of the Ethics in Government Act, 18 U.S.C. §208, many Presidential appointees are required to divest themselves of property to satisfy conflict of interest requirements. In many cases, such divestitures would result in financial losses as a result of increased tax burdens resulting from the recognition of taxable gain. It is believed that these burdens may provide a disincentive to those individuals who would otherwise accept a federal appointment.

II. The Statutory Requirements.

A. Tax Deferred Gains and Losses. The basic point of reference is Section 1031 of the Internal Revenue Code of 1986. It provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property "of like kind" which is to be held either for productive use in a trade or business or for investment. The statute requires a "roll-over" within 180 days, and provides for a carry-over cost basis from the sold property to the newly-acquired property. By its terms, the statute does not apply to stocks, bonds, or notes, or other securities or evidences of indebtedness or interest. See Section 1031(a)(2). Hence, any amendment to the Internal Revenue Code to deal with divestitures will have to modify this statute to provide for an exception to the exclusion for stocks and bonds.

B. Eligible Persons. The class of persons eligible for deferral should generally conform to the class subject to the Ethics in Government Act. For example, the eligible persons should generally include presidential appointees who are subject to Senate confirmation, equivalent-level White House officials, and persons already serving in the executive branch whenever an independent, higher authority (e.g., the designated agency ethics officer or head of the agency for agency employees; the Director of the Office of Government Ethics in the case of an agency head) determines that a potential conflict of interest cannot be resolved by a remedy other than divestiture without substantially impairing the ability of the officer or employee to carry out the duties of his or her office. The determination that divestiture is required should be in writing and made available to the public. Since the divestiture requirements apply to the holdings of the government officials themselves, their spouses, dependent children, trusts and certain other entities, such persons occupying federal positions covered by the Act and those persons related to the affected federal appointee should be eligible for tax-deferred divestitures.

C. Certification. There are a number of federal appointees who can solve their "conflicts" problems without resorting to divestiture. As a general matter, divestiture is not required by federal law. Although some government agencies require divestitures and prohibit certain holding (e.g., energy investments, defense contractor investments), the Office of Government Ethics reported in 1982 that recusals, waivers, qualified trusts and other remedies usually can cure potential conflicts of interest. For example, there are a number of cases in which compliance could be assured without a substantive limitation of the normal duties of office, including cases where the holding in question could either: (1) be placed in a qualified diversified trust; (2) meet the waiver guidelines of 18 U.S.C. ¶208(b) promulgated by the Office of Government Ethics;[1] or (3) require a recusal, the effect of which would not be a continuing generic abstention which significantly impairs the ability of the official to perform in his position. It has been suggested that the qualified diversified trust and the waiver are not practical ways to deal

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[1] The waiver guidelines embody a three-part test: (1) the total value of each such holding attributable to the interested parties represents less than 0.5% of the total value of the official's interest in property (and does not exceed $50,000); (2) such holding is not in an entity having substantial activities in the official's primary area of responsibility; and (3) if such holdings is in a trust, it is a diversified holding (less than 20% of portfolio value of such trust).

with the conflicts problem because the trust is costly to establish and the waiver delays executive decision-making. Accordingly, the tax-deferred divestiture provision should be available only for those persons for whom divestiture is determined by the Director of the Office of Government Ethics to be appropriate to assure compliance with 18 U.S.C. ¶208 and other conflict of interest statutes and regulations. In order to limit the availability of deferral, the Director should not make such a determination in any case in which compliance could be assured, other than by divestiture, without a substantive limitation of the normal duties of the appointee's office. If divestiture is required, it should apply to the entire category of tainted assets, such as energy stocks or defense industry stocks.

D. Mandatory Operation. Once an appointee is determined to be subject to divestiture with respect to a class of investment (e.g., energy stocks), the appointee subject to divestiture should not be able to claim losses on property that has declined in value below the level of his cost basis. If such were not the case, an appointee might be able to exploit the occasion of entering federal service to obtain the benefit of losses which he may not otherwise have chosen to recognize. If he also has gain property subject to divestiture, the gains could be netted out against the losses, thereby permanently eliminating tax. The tax-deferral provisions should be mandatory for all covered officials in order to avoid such individualized tax-motivated transactions. In this way, the relief measure would apply across the board to all property subject to divestiture and postpone all tax consequences that would otherwise occur as a result of divestiture.

E. The Reinvestment Vehicle. The proposal limits the tax deferral to reinvestment in "a regulated investment company which has an "approved well-diversified portfolio." The term "approved well-diversified portfolio is defined as "the portfolio of a regulated investment company which, pursuant to regulations to be recommended by the Director of the Office of Government Ethics and promulgated by the Office of Personnel Management, has been approved by such Director as meeting the standards for well-diversified portfolios as contained in regulations issued under the Ethics in Government Act."

This standard is somewhat analogous to various provisions in the Code of Federal Regulations defining financial interests that are exempted from the prohibition of 18 U.S.C. ¶208(a), as being too remote or too inconsequential to affect the integrity of an employee's services in a matter so as to require disqualification. The regulations governing the Department of Justice (28 C.F.R. §45.735-5) are representative of the standard. See also 18 U.S.C. §208(b). They define remote financial interest as - -.

> The stock, bond, or policy holdings of an employee in a mutual fund, investment company, bank or insurance company which involved in the

> matter, provided that in the case of a mutual fund, investment company or bank the fair value of such stock or bond holding does not exceed 1 percent of the value of the reported assets of the mutual fund investment company or bank.

The foregoing standard relates to disqualification (recusal) arising from private financial interests. For most government officials, investment in such a vehicle would solve conflict of interest problems and enable the appointee to make a personal investment decision before entering government service.

There may be situations, however, in which investments in a mutual fund or particular funds would not solve the conflict of interest problems of an appointee. For example, a high-level official in the Securities and Exchange Commission with authority over mutual fund regulation may not be able to invest in a mutual fund without a substantive limitation of the normal duties of office. For such individuals, the approved well-diversified portfolio could be an account maintained by the government which would guarantee a prescribed rate of interest and appreciation. With respect to such employees, the government need not actually maintain the fund but can simply dispose of all of the assets and retain the cash proceeds and pay the income to the officials from the general revenues.

Upon leaving government service, the officeholder should be allowed to roll over the cash proceeds in his account into a new investment as a condition for further postponement of taxation until those assets are sold. The 60-day I.R.A. roll-over period seems to be an appropriate time frame to make such a reinvestment. One issue that should be addressed is whether the official, during his government service, should be permitted to draw down his investment account and bear pro rate immediate taxation. The reduced income from government service suggests that this option be given to be federal officeholder in exchange for relinquishment of the tax deferral. The imposition of tax on a withdrawal would follow normal tax rules and would put the official in the same position that he would have been had he sold the stock or securities at the commencement of his government service.

F. Revenue Impact. The Conference believes that the narrow class of persons (and their dependents) subject to divestiture suggests that the revenue impact of the recommendation will be minimal. Even in a presidential transition year, the prospective and present government officials eligible for tax deferral would be less than 1,000 persons and in other years the number would be much smaller.

H. Treasury Objections. When the proposal was originally circulated within the Executive Branch, the Treasury expressed opposition. In the Treasury's view, the proposal could not be distinguished from other situations in which taxpayers are compelled by personal circumstances to sell stock (e.g., to pay medical bills or to pay business losses). But in those situations, the taxpayer is actually "cashing in" his investment. Here, on the other hand, a narrowly defined class of persons is simply changing the form of their investment pending the completion of their government service. Moreover, the fact that acceptance of a federal appointment is a voluntary act should not mean that it must be accompanied by onerous tax consequences.

Second, the Treasury argued that the proposal would create an undesirable incentive to enter government service for the special tax benefits that would be available. While there are many considerations that prompt people to accept federal appointment, it is hard to imagine that the proposal would improperly encourage people to enter government service. The narrow scope of affected persons is a sufficient rebuttal to the charge that enactment would make it more difficult to resist broader rules that would permit most taxpayers to roll over investments.

Third, in 1982, the Treasury argued that the 20% capital gains rate was sufficiently low so as not to be a burden for prospective nominees. But the capital gains preference has now been eliminated for tax years after 1987. Thus, the tax burdens arising from divestiture are now substantially greater than they were six years ago.

Finally, the Treasury expressed concern about the equity of a proposal that would provide significant financial benefits to the few appointees who are faced with a potential tax on capital gains. At the same time, no tax benefits are available to career government employees and those appointees who do not have substantial investment in stock. The benefits, however, are temporary in nature. All that the proposal seeks to accomplish is to permit a potential appointee to make a decision with respect to federal service without regard to the negative tax consequences that would otherwise result. Consideration of federal service should be a tax neutral decision. The fact that the proposal addresses a narrow concern, rather than bestowing largesse upon the entire civil service, is an argument in favor of its enactment rather than evidence that it is inequitable.